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## **Trade in environmental goods: how important are trade costs elasticities?**

Lota D. Tamini  
Zakaria Sorgho

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**Tamini:** Professor at the Department of Agricultural Economics and Consumer Science, Université Laval and CREATE, Pavillon Paul-Comtois, 2425, rue de l'Agriculture, local 4412, Québec (QC), G1V 0A6, Canada. Email: [lota.tamini@eac.ulaval.ca](mailto:lota.tamini@eac.ulaval.ca)  
**Sorgho:** Department of Agricultural Economics and Consumer Science, Université Laval and CREATE

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## Trade in environmental goods: how important are trade costs elasticities?

Lota D. Tamini<sup>1</sup>

Associate Professor, Laval University, Department of Agricultural Economics and Consumer Science and Center for Research on the Economics of the Environment, Agri-food, Transports and Energy (CREATE), Laval University.

Corresponding author: [lota.tamini@eac.ulaval.ca](mailto:lota.tamini@eac.ulaval.ca)

Zakaria Sorgho

Center for Research on the Economics of the Environment, Agri-food, Transports and Energy, Laval University

[zakaria.sorgho@ecn.ulaval.ca](mailto:zakaria.sorgho@ecn.ulaval.ca)

### *Abstract*

Negotiations on the liberalization of environmental goods (EGs) and services within the WTO Doha Round (mandated in November 2001) are facing specific challenges. Conflicting interests and differing perceptions of the benefits of increased trade in EGs were reflected in different approaches proposed for determining EGs. Using import data of 34 OECD member countries and from a sample of 167 countries, from 1995 to 2012, we discuss the trade effect of reducing barriers on EGs. We analyze the lists of EGs proposed by the Asia-Pacific Economic Cooperation (APEC) and the Organisation for Economic Co-operation and Development (OECD) using a Translog gravity model. We found that removing tariff barriers for EGs will have a modest impact because for the biggest importers and exporters, elasticities of trade costs are very low while for most trading relationships they are very high, making it difficult for exporters to maintain their markets. Overall, our results suggest that, because of their substantial effect on international trade, future negotiations on EGs should also address the issues of standards and nontariff barriers (NTBs).

***JEL classification:*** F11, F12, F15

***Keywords:*** Environmental Goods, Translog, Gravity, Trade costs elasticity, Import share

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## **Trade in environmental goods: evidences from an analysis using elasticities of substitution**

*“We simply cannot proceed with business as usual – if our planet is to be preserved for future generations – we must protect our resources, our planet’s biodiversity and our environment at large”. [...] “the leaders that founded our organization were adamant that sustainable development lies at the very core of our mission.”*

Pascal Lamy, WTO Director-General, 5 June 2010.

### **1 Introduction**

Several studies have investigated the environmental impact of international trade, yet their results are inconclusive (Managi, Hibiki and Tsurumi, 2009; Copeland and Taylor, 2004). This ambiguity comes from the three channels of transmission of the effects of trade on environmental quality, i.e. scale effects associated with income level, composition effects (the different sectors of the economy have different effects on emissions) and technical effects that cause some production techniques to be less polluting than others. However, Frankel and Rose (2005) also emphasize the importance of the assumption of gains from trade whereby trade leads to “cleaner” consumption patterns through higher incomes. In this case, trade would promote the diffusion and use of technological innovations. The acceleration of trade and clean technology transfer are central to the sustainable development strategy of the World Trade Organization (WTO) and the Asia-Pacific Economic Cooperation (APEC). One of the options discussed in the two institutions involves tariff liberalization in environmental goods and services.<sup>2</sup>

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<sup>2</sup> See OCDE (2006) for a definition.

According to the WTO and APEC, liberalization<sup>3</sup> of trade in environmental goods (EGs hereafter) would simultaneously favor environmental protection and economic development.<sup>4</sup> Better environmental protection results from two distinct effects. First, firms would probably increase their pollution abatement efforts because of the reduced prices resulting from an import tariff cut. Second, because of this reduction in environmental compliance costs, governments would be encouraged to set more ambitious environmental standards.

In the ongoing discussions at the WTO, several approaches to identify EGs have been proposed: list of products, requests and offers, integrated projects and a mix of the previous approaches. For Balineau and De Mello (2013), conflicting interests and differing perceptions of the benefits of the intensification of trade in EGs explain the different approaches proposed. Each approach has implications for the impact of liberalization on sustainable development. Indeed, an approach based on lists of products could increase the comparative advantage of certain economies because international trade of EGs is dominated by developed countries, which represent 90% of world supply (GIER, 2009). Given that developing countries are net importers, greater liberalization of trade in environmental goods could worsen their trade deficits. This pattern of the world trade of EGs has an implication that Vikhlayev (2004) describes as uncomfortable: trade gains would be for developed countries and environmental gains for developing countries. Moreover, the applied

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<sup>3</sup> Lovelley and Popp (2011) find that economic integration increases access to environmentally friendly technologies and leads to earlier adoption.

<sup>4</sup> See Article 31.3 of the Doha Declaration for WTO Strategy at <http://www.international.gc.ca/media/comm/news-communicues/2014/01/24a.aspx> [Accessed January 25, 2015].

tariffs of EGs are relatively low and are not much higher than those of other industrial products (Balineau and de Melo, 2013; Vossenaar, 2013).<sup>5</sup>

In September 2012, Asia-Pacific Economic Cooperation (APEC) Leaders endorsed the APEC List of Environmental Goods. In addition, the commitment adopted in 2011 to reduce applied tariffs to 5 percent or less by the end of 2015 was reaffirmed.<sup>6</sup> At the 2014 Davos Summit, 14 World Trade Organization (WTO) members<sup>7</sup> announced their intention to negotiate a plurilateral agreement that would eliminate tariffs on an array of environmental goods.<sup>8</sup> However, very few studies have addressed the impact of EGs liberalization, even though this is a timely issue for the WTO and APEC. Because of low tariff levels, differentiated liberalization of trade of EGs may not result in environmental gains. It is therefore important to assess the extent to which the sustainable development objectives of the WTO and APEC can be achieved by differentiated liberalization of trade in environmental goods.

The theoretical and empirical literature on industries producing environmental goods and services (eco-industries) is relatively recent. Examples of theoretical works are Nimubona and Benchekroun (2014), David and Sinclair-Desgagné (2010), Nimubona (2010), and Canton,

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<sup>5</sup> According to Balineau and de Melo (2013), countries that participated in the submission list process have average effective applied tariffs on the goods in this comprehensive list that were less than their average protection for all goods.

<sup>6</sup> See at [http://www.apec.org/Press/Features/2014/0115\\_egs.aspx](http://www.apec.org/Press/Features/2014/0115_egs.aspx) [Accessed January 25, 2015].

<sup>7</sup> These countries are Australia, Canada, China, Costa Rica, the European Union, Hong Kong, Japan, Korea, New Zealand, Norway, Singapore, Switzerland, Taiwan, and the United States. They account for 86% of global trade in environmental goods. See the US government website at <http://www.ustr.gov/about-us/press-office/press-releases/2014/January/Froman-ministers-launch-new-talks-toward-increased-trade-environmental-goods> [Accessed January 25, 2015].

<sup>8</sup> De Melo (2015) asserts that current climate change negotiations face difficulties because of the inability to obtain full participation. However, an EGs agreement requires the participation of only a small number of countries to reach the level of 90% of world trade in EGs, which is the condition for extending the reductions negotiated to all WTO members.

Soubeyran and Stahn (2008). One of the recurring problems noted is the existence of entry barriers in this specialized industry, and its concentration (David, Nimubona and Sinclair-Desgagné, 2011). The empirical implication of the structure of the eco-industry on international trade flows of EGs is of interest. In fact, international trade of EGs has been poorly studied empirically. Zugravu (2010) addresses the EGs issue systematically using the approach proposed by Frankel and Rose (2005), which features an estimation of a system of equations. The author shows that for “transition countries,” EGs’ trade intensity has a negative net impact on pollution, and that EGs classification is important when analyzing the impacts.<sup>9</sup> More recently, He *et al.* (2015) studied the impact of trade liberalization on EGs exports within 20 Asia-Pacific Economic Cooperation members. These authors show that even if tariff and nontariff barriers reduction would have a positive impact on exports, considerable heterogeneity exists according to countries’ income levels.

However, the empirical studies on EGs assume a constant elasticity of substitution even if recent research has highlighted the fact that reducing trade costs may lead to increased competition and lower margins (e.g. Melitz and Ottaviano, 2008; Feenstra and Weinstein, 2010; Badinger, 2007; Chen, Imbs and Scott, 2009). Given the structure of production and international trade in the EGs sector, assuming a constant elasticity of substitution is more difficult to justify. For instance, one can expect a high absolute value of elasticity of substitution when imports are low, or when the importer is much larger than the exporter.<sup>10</sup> These conditions make it harder for small exporters of EGs to defend their market share (also see Belineau and de Melo, 2013; He *et al.*, 2015). The

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<sup>9</sup> Zugravu (2010) shows that, to increase EGs trade, attention must be paid not only to liberalization issues but also to cross-country harmonization of institutional quality, and especially, to environmental regulations.

<sup>10</sup> Also see a discussion on the implications of relaxing CES preferences in Mrazova and Neary (2014).

situation should be better modeled by functions where the elasticity of substitution is not constant (Feenstra, 2003, 2010; Novy, 2013).

Following the few empirical studies on this topic, we specify a gravity model with non-constant elasticity of substitution (Novy, 2013; Gohin and Femenia, 2009<sup>11</sup>). We assume Translog preferences because, as mentioned by Novy (2013: 272), they are more flexible and allow a richer substitution patterns. Non-constant elasticity of substitution assumption is appropriate when analyzing EGs, given the particular structure of production and international trade within this industry. The approach for estimating gravity equations uses fixed effects to circumvent the difficulty associated with the nonlinear character of the multilateral resistance indices. Our results confirm the hypothesis that the elasticities of substitution depend on the size of the importing country and the number of EGs imported from a specific supplier. Therefore, the gains from liberalization would be modest for most countries, and those already dominating international trade in EGs would strengthen their positions. Reducing tariffs on the APEC List of EGs should be more favorable to international trade than those on the list proposed by the OECD. Our results show that the attainment of environmental and development objectives of the WTO and APEC could be attained through (i) parsimonious identification of EGs and (ii) the establishment of mechanisms for the transfer of clean technologies because trade costs impacts are greater for "small" economies.

The rest of the paper is structured as follows. Section 2 presents some facts about international trade of EGs, while section 3 presents the empirical modelling. Section 4 describes the data and

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<sup>11</sup> Gohin and Féménia (2009) suggest that the CES-based gravity approach is not supported by data when looking at trade in food products. The authors use an Almost Ideal Demand System (AIDS) model but do not derive a gravity-type model when explaining trade flows between countries. Feenstra and Weinstein (2010) also provide theory and some evidences for the US.

discusses the estimation methods. The estimation results and robustness check are presented in section 5. Section 6 discusses trade costs elasticities (TCEs) on EGs' trade, and the last section concludes the paper.

## **2 International trade of EGs**

EUROSTAT (2009) suggests that only technologies, goods and services that have been produced for environmental purpose should be included in the environmental sector. Nonetheless, according to the U.S. Office of Technology Assessment (1994, p.149), cited by the OCDE (2006), there is no “environmental goods sector” that is fully defined as such. Rather, this sector comprises suppliers of many types of goods, services and technologies that are integrated in regular production processes, and it is often difficult to treat them as separate elements. Balineau and de Melo (2013) discuss the difficulties and obstacles in selecting environmental goods. Few countries (only 13) have adopted a list approach, and there is little overlap across submissions (Balineau and de Melo, 2013). The lists of EGs that serve as a framework for discussions have been developed by the Organization of Economic Cooperation and Development (OECD) and Asia Pacific Economic Cooperation (APEC). The OECD List resulted from joint OECD and Eurostat work on a manual designed to help national statisticians to measure their environmental industries (OCDE, 2006). The list is broad because adding products to the list had no particular policy consequences. However, because it first identified goods, the APEC approach yielded a smaller list of goods. Table 1 presents the number of goods included in the two lists.<sup>12</sup> Goods included in the lists are defined by the harmonized system at 6 digits (HS6).

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<sup>12</sup> In the present study we adjust the OECD List by dropping services, and keeping only goods.



<<< Table 1 about here >>>

Table 2 presents the relative share of trade for the ten leading countries for the years 2003 and 2012, when considering the APEC and OECD proposals. It indicates that even if the two lists differ, the same countries are represented. In 2012, total exports of EGs by the ten leading countries represent 76.03% of the trade value of goods included in the APEC List and 69.19% for the OECD List. In 2003 the picture was similar for the APEC List (77.49%), whereas for the OECD List the share of trade value of the ten leading countries was higher, at 82.47%. The total share of imports of the ten leading countries is more stable: from 74.63% to 61.41% for the APEC List and from 61.14% to 56.42% for the OECD List.

<<< Table 2 about here >>>

From 2003 to 2012, trade of EGs under the APEC List grew by 156.44%, whereas growth was 133% for the OECD List.<sup>13</sup> Figure 1 indicates that the value of trade in environmental goods increased continually since 2003 (except in 2008-2009 due to the economic crisis). It also indicates that the growth occurs mainly at the intensive margin<sup>14</sup> because of an increase in the average value of a bilateral trade flow.

<<< Figure 1 about here >>>

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<sup>13</sup> During the same period, the growth in value of trade of industrial goods including environmental goods was 133.59%.

<sup>14</sup> In the literature, the term *extensive margin* refers to the growth in exports stemming from the emergence of new destinations (e.g. Felbermayr and Kohler, 2006) or new exported varieties (e.g. Hummels and Klenow, 2005), or the participation of new firms on export markets (Chaney, 2008; Helpman, Melitz and Rubinstein, 2008). Growth in trade at the *intensive margin* refers to an increase in the trade volume between existing partners, in the trade volume of existing varieties or in the export volume of firms currently engaged in export activities.

Current negotiations<sup>15</sup> intend to build on and expand a list of 54 environmental goods for which Asia Pacific Economic Cooperation (APEC) countries agreed in 2011 to reduce tariffs to 5% or less by 2015. As mentioned by the OCDE (2006), both the OECD and the APEC lists have helped frame the WTO negotiations on EGs. Belineau and de Melo (2013), among others, also mention the WTO list of 411 goods. This list merges the lists of EGs proposed by some countries. The core list of WTO List of EGs includes 26 goods. However in our paper we analyze the APEC and OECD lists because they are central to current negotiations, especially the APEC list.

### 3 Empirical model

Our specification of the gravity equation follows Novy (2013). We deal with the non-constant elasticity of substitution regarding the country's market share and the number of EGs being traded. The Translog expenditure function denoted by  $E_j$  is given by (see Feenstra, 2003):

$$(1) \quad \ln(E_j) = \ln(U_j) + \alpha_{0j} + \sum_{m=1}^N \alpha_m \ln(p_{mj}) + \frac{1}{2} \sum_{m=1}^N \sum_{k=1}^N \gamma_{km} \ln(p_{mj}) \ln(p_{kj})$$

where  $U_j$  is the utility level of country  $j$  with  $m$  and  $k$  the goods and  $\gamma_{km} = \gamma_{mk}$ .<sup>16</sup> The price of good  $m$  in country  $j$  is  $p_{mj}$ . The expenditure share  $s_{mj}$  of country  $j$  for good  $m$  can be obtained by differentiating the expenditure function (1) with respect to  $\ln(p_{mj})$

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<sup>15</sup> See the US government website at <http://www.ustr.gov/about-us/press-office/press-releases/2014/January/Froman-ministers-launch-new-talks-toward-increased-trade-environmental-goods> [Accessed January 25, 2015].

<sup>16</sup> Homogeneity condition requires that  $\sum_{m=1}^N \alpha_m = 1$  and  $\sum_{k=1}^N \gamma_{km} = 0$ .

$$(2) \quad s_{mj} = \alpha_m + \sum_{k=1}^N \gamma_{km} \ln(p_{kj})$$

Following Anderson and van Wincoop (2003), Novy (2013) derives a Translog gravity equation from the import share by solving for the equilibrium prices:

$$(3) \quad \frac{x_{ij}}{y_j} = \frac{y_i}{y^w} - \gamma n_i \ln(\tau_{ij}) + \gamma n_i \ln(T_j) + \gamma n_i \sum_{s=1}^j \frac{y_i}{y^w} \ln\left(\frac{\tau_{is}}{T_s}\right)$$

where  $x_{ij}$  represents country  $j$ 's imports from country  $i$ ,  $y_j$  ( $y_i$ ) represents country  $j$ 's ( $i$ ) expend

on EGs,  $y^w$  denotes world expend on EGs, defined as  $y^w \equiv \sum_{j=1}^J y_j$  and  $n_i \equiv N_i - N_{i-1}$  denotes the

number of EGs traded by the exporter country  $i$ . Thus,  $\ln(T_j)$  is the weighted average of logarithm of trade costs:

$$(4) \quad \ln(T_j) = \sum_{k=1}^N \omega_k \ln(\tau_{kj}),$$

where  $\omega_k = x_{kj} / \sum_{k=1}^N x_{kj}$  is the weight of the importing country  $k$  from the exporting country  $j$ . The

trade-adjusted Translog gravity equation<sup>17</sup> is then:

$$(5) \quad \frac{x_{ij}}{y_j} = n_i \ln(\tau_{ij}^\gamma) + n_i S_j + S_i,$$

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<sup>17</sup> The corresponding ‘‘traditional’’ or CES gravity equation is:  $\ln(x_{ij}/y_j) = \ln(\tau_{ij}^{1-\sigma}) + S_i + S_j + \zeta_{ij}$  where  $S_i = (\Pi_i)^{\sigma-1} + y_i/y^w$  and  $S_j = (P_j)^{\sigma-1}$ . This specification implies a constant elasticity of substitution  $\eta^{CES} = (1-\sigma)$ .

where  $S_j \equiv \gamma \ln(T_j)$  is the importer fixed effect and  $S_i \equiv \frac{y_i}{y^w} + \gamma n_i \sum_{s=1}^j \frac{y_i}{y^w} \ln\left(\frac{\tau_{is}}{T_s}\right)$  the exporter

fixed effect. From equation (5), the estimating equation<sup>18</sup> is:

$$(6) \quad \frac{x_{ij}/y_j}{n_i} = \ln(\tau_{ij}^\gamma) + S_j + \Gamma_i + \varepsilon_{ij},$$

where  $\Gamma_i \equiv S_i/n_i$  and  $\varepsilon_{ij}$  is a mean-zero error term. Trade costs  $\tau_{ij}$  includes the effect of distance and some factual factors of trade preference (trade agreement, common language and borders, etc.):

$$(7) \quad \tau_{ij}^\gamma = \exp\left(\beta \ln(dist_{ij}) + \kappa_1 border_{ij} + \kappa_2 language_{ij} + \kappa_3 legal_{ij} + \kappa_4 RTA_{ij}\right)$$

where the variable *language* takes the value of 1 if the trading partners share a common language and 0 otherwise, the variable *border* takes the value of 1 if the trading partners share a common border and 0 otherwise and the variable *legal* takes the value of 1 if the two trading partners have a common legal system and 0 otherwise. Finally the variable RTA takes the value of 1 if the two trading partners are both members of at least one regional trading agreement. The parameter  $\beta$  measuring the impact of distance in trade costs elasticity and the vector of parameters  $\kappa$  represents the impacts of the other trade costs factors. Given the gravity equation (6) and trade costs equation (7), we define our Translog trade costs elasticity (TCE) as:

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<sup>18</sup> This specification is preferred because “any possible measurement error surrounding  $n_i$  is passed on to the left-hand side and estimation can be carried out with both exporter and importer fixed effects, as is frequently done in the gravity literature” (Novy, 2013, p.275).

$$(8) \quad \eta_{ij}^{TL} = -\frac{\gamma n_i}{(x_{ij}/y_j)}$$

*Ceteris paribus*, the absolute value of the elasticity increases (i) when import share decreases (imports are small and importers are sensitive to small changes in prices), (ii) when the size of the importing country increases (because of a like *monopsony power* of the importer) and (iii) when the number of exported goods increases (because of higher competition between substitute goods). As a result, it is more difficult for small exporters to defend their market share. All these conditions are expected for international trade in environmental goods.

## 4 Data and estimation methods

### 4.1 Data description and sources

Our sample data include OECD importing countries and 167 exporting countries. (see Table A1 in the appendix). This study covers the period of 1995 to 2012. Trade data on EGs are obtained from the UN Comtrade database<sup>19</sup> referring to the EGs lists proposed by APEC and OECD. EGs trade is defined at the six-digit level using the harmonized system (HS6). Transport cost proxies are important variables in gravity models. Previous studies have found that trade elasticities with respect to transport cost and other transaction cost variables are sensitive to the method used to proxy transport cost (Head and Mayer, 2002). Some authors designed more intricate measures that take into consideration the dispersion of economic activity within a region. Head and Mayer (2002) suggest the following indicator:

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<sup>19</sup> Data on trade were collected using World Integrated Trade Solution (WITS) software (See <http://wits.worldbank.org/wits/>).

$$(9) \quad d_{ij} = \sum_{g \in i} \left( \sum_{h \in j} \varpi_h d_{gh} \right) \varpi_g$$

Where  $d_{gh}$  is the distance between the two sub-regions  $g \in i$  and  $h \in j$  and  $\varpi_g$  and  $\varpi_h$  represent the economic activity share of the corresponding sub-region. The *Centre d'Études Prospectives et d'Informations Internationales (CEPII)* uses the above formula to create a dataset. To take into account a potential impact of the crisis of 2008-2009, we add a dummy variable that controls for this impact when estimating the gravity equation. Data on language, legal system and sharing a common border also come from the CEPII database. Table 3 presents some descriptive statistics of the variables of interest.

<<< Table 3 about here >>>

#### 4.2 Expend on EGs ( $y_j$ ) and number of traded goods ( $n_i$ )

The number of traded goods ( $n_i$ ) and country  $j$ 's expend on EGs ( $y_j$ ) are sensitive when computing trade elasticities. Thus, the number of EGs from the exporting country ( $n_i$ ) is defined as a proxy of the extensive margin to trade. However, the values of  $n_i$  have been normalized by dividing it by its maximum value.<sup>20</sup>

Expend on EGs is calculated using the following formula:

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<sup>20</sup> Before normalization, the number of EGs from the exporting country ( $n_i$ ) is widely dispersed: with a maximum value of 112 (and a minimum value = 0) for OECD List, and a maximum value of 54 (and a minimum value = 0) for the APEC List. This requires standardization to control the effects of higher/lower values. Also see Hummel and Klenow (2005).

$$(10) \quad y_j = Production_j - \sum_{-j} Exports + \sum_{-j} Imports$$

where, for country  $j$ ,  $Production_j$  is industrial production in the EGs sector,  $\sum_{-j} Exports$  are total exports of EGs and  $\sum_{-j} Imports$  are total imports of EGs. Data on production come from United Nations Industrial Development Organization (UNIDO) Statistical Databases.<sup>21</sup>

### 4.3 Estimation procedure

To estimate the gravity equation, we use Heckman's two-step estimation procedure (1979) when correcting for zeroes.<sup>22</sup> As shown by Baldwin and Taglioni (2006) and many others, to properly identify the elasticity of trade policy in a gravity panel setting, you need to control for time-varying importers' and exporters' fixed effects. This is because multilateral resistances are not time-invariant. Moreover, Baier and Bergstrand (2007) suggest that the best way to account for endogeneity due to omitted variable bias (and other endogeneity issues) is to also use time invariant pair-fixed effects (see also Martínez-Zarzoso, Felicitas and Horsewood, 2009; Raimondi, Scoppola and Olper, 2012). Accordingly, our estimating equation (6) includes exporter and importer time-variant fixed effects respectively and a time-invariant country-pair effect  $\Upsilon_{ij}$  with  $\Upsilon_{ij} \neq \Upsilon_{ji}$ .

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<sup>21</sup> See <https://stat.unido.org/home>. [Accessed March 2, 2015] and the concordances at <http://unstats.un.org/unsd/cr/registry/regot.asp?Lg=1> [Accessed January 25, 2015], and [http://wits.worldbank.org/wits/product\\_concordance.html](http://wits.worldbank.org/wits/product_concordance.html) [Accessed January 25, 2015]

<sup>22</sup> Santos Silva and Tenreyro (2006) suggest the use of the Poisson pseudo-maximum likelihood (PPML) procedure to estimate the multiplicative form of the gravity equation. They showed that the PPML procedure yields consistent estimates in the presence of heteroskedasticity. However, as indicated by Olivero and Yotov (2012), in estimating a size-adjusted gravity model we deal with expenditure endogeneity as well as the important issue of heteroscedasticity.

## 5 Estimation results

### 5.1 Benchmark results

Table 4 presents the estimation results based on equation (6).<sup>23</sup> As in Novy (2013), overall our estimates are smaller than those found in the literature using a CES gravity model (e.g. Head and Mayer, 2013). For the two models (Translog and CES gravity), the estimated coefficients of the variables are significant at least at 1% level and have the expected sign. Our results also confirm that EGs' trade flows are fostered by sharing a border and/or language, and a common legal system. From Translog results only “common language” and “common legal system” appear statistically non-significant at 5% (but with the expected sign) respectively for OECD List and APEC List. As anticipated, the import share divided by the extensive margin  $\left(\frac{x_{ij}/y_j}{n_i}\right)$  as a dependent variable is negatively correlated with geographic distances between trading countries. And, the distance coefficient of OECD List (column 1) is smaller in absolute value than those of the APEC List (column 2). Finally, the control parameter for correcting selection bias, the Inverse Mills Ratio (IMR), is highly significant (at 1% level). These results suggest that the *2-stage Heckman* model is relevant.

<<< Table 4 about here >>>

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<sup>23</sup> The first stage Probit results are reported on Table A2 in the appendix.



## 5.2 Robustness checks

### 5.2.1 *Alternative trade costs specifications*

We test the stability and consistency of our results regarding the estimated coefficient on “distance” which is at the core of our study on trade costs elasticities. In doing so, we use three different modifications of the benchmark model. Table 5 presents the estimated results. In Column 1, we use a specification with only the distance as a proxy of trade costs. Column 2 presents our estimation results with variable distance as well as interaction variables between distance and the factors variables included in the benchmark model (i.e. “common border”, “common language”, “common legal” and “RTA”). Finally in Column 3, the model includes the variables considered in the benchmark model as well as interaction variables between distance and the factors variables. Overall the estimated coefficients of the distance are close to those of the benchmark estimations.

<<< *Table 5 about here* >>>

### 5.2.2 *Alternative expend specification*

Expend on EGs is calculated using the following formula of equation (10). However, environmental goods trade data are at a more disaggregated level (HS6) than production data (ISIC 3) because the latter encompass more than environmental sectors. As a robustness check we re-estimate the model using total imports  $\left(\sum_{-j} Imports\right)$  as a proxy of total expenditures on EGs. The estimated results presented on Column (4) of Table 5 are qualitatively similar to those

of the benchmark model. The use of the formula of equation (10) or the total imports as the proxy of total expend would not change the estimated values of TCEs.

## 6 Analysis of trade costs elasticities and environmental goods trade

Referring to the two main EGs lists (APEC and OECD), we discuss the potential trade effect of a possible liberalization of EGs (e.g. reducing barriers to trade on EGs). To discuss the trade implications of potential liberalization, we calculate the TCEs.

Recall that the TCE  $\eta_{ij}^{TL}$  depend on the Translog parameter  $\gamma$ , the import share  $x_{ij}/y_j$  and the number of goods of the exporting country  $n_j$  (equation (8)). We directly obtain the values for  $x_{ij}/y_j$  and  $n_j$  from the data. In the Translog gravity equation (6), the distance coefficient corresponds to the parameter combination  $\gamma\beta$ . Thus, the value for parameter  $\gamma$  can be retrieved from the estimated distance coefficient in Translog estimates, but we need the value for parameter  $\beta$ . As suggested by Novy (2013, p.278), we retrieve the value of  $\beta$  from the standard gravity equation where the estimated distance coefficient corresponds to the parameter combination  $-(\sigma - 1)\beta$ . According to the gravity literature, we assume elasticity of substitution equal to  $\sigma = 8$  as used by Novy (2013),<sup>24</sup> which simply gives a constant equal to  $\sigma - 1 = 7$ . In sum, the value for parameter  $\gamma$  can be obtained by  $7 * (\beta^{translog} / \beta^{traditional})$ .<sup>25</sup>

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<sup>24</sup> Based on survey data, Anderson and van Wincoop (2004) suggest that the elasticity of substitution is approximately the middle of the range [5; 8].

<sup>25</sup> The parameters  $\beta^{translog}$  and  $\beta^{traditional}$  are respectively the estimated distance coefficient from the Translog and CES gravity models.

Based on import shares  $(x_{ij}/y_j)$ , we subdivide our sample into ten quantiles and calculate the mean TCE for each quantile reported on Table 6. Indeed, the estimated TCEs vary across import shares. These results suggest that the reduction of tariff barriers in EGs, featured prominently in the Doha Round negotiations and decided by the APEC, appears to have a modest trade effect when considering the main importers of EGs (see last quantiles). Further, as expected, TCEs are higher when import shares are low. It is only for the higher 30% trade flows that elasticity of trade costs is “reasonable.” For the other quantiles, TCEs are very high, implying that exporters cannot maintain their markets.<sup>26</sup> TCEs are very low for the last quantile, which mostly includes the relationship between developed countries. The main reason for this low impact is that on average, EGs are less tariff-protected than other goods. Countries reduced protection by about 50% from initial levels in 1996 (Balineau and de Melo, 2013, p.715) which favored the increase of international trade in EGs.<sup>27</sup>

<<< Table 6 about here >>>

Figure 2 illustrates the relationship between TCEs and import shares for each EGs list and for the periods 2003-2007 and 2008-2012. Trade costs elasticities exhibit more heterogeneity within the APEC List, and this heterogeneity comes from the number of imported goods from a given origin.

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<sup>26</sup> Several studies also point out the difficulties faced by exporters from developing countries and especially from the least developed countries (LDCs) because of non-harmonized international standards and nontariff barriers (NTBs) (Cosbey, 2008).

<sup>27</sup> In addition, in 2012, APEC member countries committed to reducing the applied tariff rates of 54 EGs (six-digit HS codes) to 5% or less by the end of 2015 (He *et al.*, 2015, p.14). Tariffs are less important in restricting imports over time, while nontariff barriers (NTBs) are more commonly used to regulate imports of EGs (He *et al.*, 2015; de Melo, 2015). Indeed, lowering the importing country’s NTBs tends to increase its imports as well, as mentioned in previous studies (see Looi Kee, Nicita and Olarreaga, 2009). Thus, in future trade negotiations on EGs, attention should be paid to reducing NTBs and to trade in ecological services (de Melo, 2015).

One interpretation for this is that the APEC EGs list is more specific and “specialized” than the OECD list, which identifies more products.

<<< *Figure 2 about here* >>>

Otherwise, Figure 3, which represents the TCEs for six selected countries (Germany, United States of America, Canada, France, Japan, and Great Britain), indicates that, for the members of APEC (United States of America, Canada and Japan), the elasticity of trade costs has the same pattern for the two lists. This is not the case for Germany, Great Britain and France, where the difference in trade costs between the two lists is clearly highlighted.

<<< *Figure 3 about here* >>>

However, Figure 2 indicates that, when comparing the period 2003-2007 to the period 2008-2012, TCEs decline over time for the APEC list while it is relatively stable for the OECD one. For selected countries, Figure A1 confirms that the pattern of TCEs remains relatively stable from the period 1998-2002 to the period 2008-2012 for the OECD List, but this is not the case for the APEC List, for which the trade costs declined. This consequently reduces the differences between the two lists.

Finally, we graphically analyze TCEs regarding (i) EGs trade intensity defined by  $(import + export)_{List=APEC,OECD}$  and (ii) EGs trade openness index defined as

$$\left( \frac{import + export}{EGs\ production\ value} \right)_{List=APEC,OECD}$$

As pointed out in Figure 4 (top panel), the biggest trading countries of EGs (e.g. Japan, United States and Germany) have low trade costs on average. Figure 4 also shows, for example, that

trade costs for EGs for Canada and Mexico are the highest for the OECD List, while these costs are highest for Poland and Canada for the APEC List.<sup>28</sup> A possible explanation is that these countries increase their NTBs while lowering their tariffs. When considering countries' EGs trade openness index, the bottom panel of Figure 4 shows that TCEs are more dispersed when considering the APEC List of EGs while they are less dispersed for the OECD List. This result confirms that the APEC List is more specific and specialized than the OECD one.

<<< *Figure 4 about here* >>>

## 7 Concluding remarks

The negotiations on the liberalization of environmental goods within the WTO Doha Round face some specific challenges: (a) definitional issues related to environmental goods (EGs), (b) complexities regarding their classification for customs purposes, and (c) development issues and North-South cleavages. In sum, the modalities of liberalization remain contentious.

Little progress has been made to define an approach to reducing protection of EGs. However, the “list approach,” even if controversial, seems to be favored in current negotiations on environmental goods liberalization. Conflicting interests and differing perceptions of the benefits provided by EGs were reflected in different proposals determining EGs (APEC List, OECD List, Integrated List, etc.). In principle, trade liberalization by lowering the costs of EGs allows consumers (industries and/or households) to purchase them. Using an analysis of trade costs

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<sup>28</sup> From 1996 to 2011 the average share of duty-free imports of EGs rose by 73.17 percentage points (He *et al.*, 2015).

elasticities, our paper indirectly explores the impact of trade liberalization on EGs when considering the lists proposed by APEC and OECD.

Given the particular structure of production and international trade within EGs industries, we present one of the very few empirical studies to specify a gravity model that assumes Translog preferences. Our results confirm the hypothesis of non-constant elasticities of substitution, in that elasticities of substitution are a function of the size of the importing country and the number of EGs imported from a specific supplier. Removing tariff barriers for EGs will have a modest impact on their trade for two reasons. First, for most trading relationships, TCEs are very high, making it difficult for exporters to maintain their markets. This result could explain why developing countries have been reluctant to negotiate tariff reductions. Second, for the biggest importers and exporters, TCEs are very low. Our TCEs analysis pointed out that the countries that trade EGs the most (e.g. Japan, United States and Germany) have low average trade costs. Therefore, the expected gains of developed countries from participating in multilateral negotiations on EGs would come from reductions in tariffs for developing countries, where tariffs are higher than in developed countries. Overall, our results suggest that, because of their substantial effect on international trade, future negotiations on the liberalization of trade in environmental goods should also address the issue of nontariff barriers (NTBs) and non-harmonized standards raised by recent studies.

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## List of tables

**Table 1.** Summary statistics of APEC and OECD Lists of EGs

	Number of tariff line (HS6 digit)
OECD's adjusted list	112
APEC's 2012 list	54
Composite list	138
Overlap of the two lists	27

**Table 2.** Top ten importers and exporters of EGs

<b>APEC List</b>				<b>OECD List</b>			
2003							
<b>Total value of trade (x10<sup>3</sup>USD): 1.63 10<sup>8</sup></b>				<b>Total value of trade (x10<sup>3</sup>USD): 2.18 10<sup>8</sup></b>			
<b>Imports</b>		<b>Exports</b>		<b>Imports</b>		<b>Exports</b>	
Country	Share	Country	Share	Country	Share	Country	Share
USA	13.72%	USA	20.87%	USA	15.95%	DEU	17.53%
CHN	13.13%	DEU	15.60%	DEU	7.79%	USA	17.20%
DEU	8.35%	JPN	15.03%	CHN	7.78%	JPN	11.20%
JPN	5.12%	GBR	4.77%	FRA	5.29%	ITA	6.09%
KOR	4.74%	KOR	4.34%	CAN	5.09%	FRA	4.91%
GBR	4.37%	FRA	4.20%	GBR	4.58%	GBR	4.37%
CAN	4.15%	ITA	3.97%	JPN	3.90%	CHN	4.35%
FRA	4.04%	CHE	3.11%	KOR	3.66%	MEX	3.09%
MEX	3.73%	CHN	3.09%	ITA	3.55%	CAN	2.85%
ITA	3.30%	MEX	2.51%	MEX	3.54%	NLD	2.37%
ROW	35.37%	ROW	22.51%	ROW	38.86%	ROW	17.53%
2012							
<b>Total value of trade (x10<sup>3</sup>USD) : 4.18 10<sup>8</sup></b>				<b>Total value of trade (x10<sup>3</sup>USD) : 5.08 10<sup>8</sup></b>			
<b>Imports</b>		<b>Exports</b>		<b>Imports</b>		<b>Exports</b>	
Country	Share	Country	Share	Country	Share	Country	Share
CHN	16.68%	DEU	14.40%	USA	14.52%	DEU	16.11%
USA	12.71%	USA	14.40%	CHN	9.81%	USA	13.38%
DEU	7.93%	JPN	12.52%	DEU	7.84%	CHN	10.01%
KOR	4.46%	CHN	12.18%	FRA	3.85%	JPN	9.62%
JPN	3.75%	KOR	8.47%	CAN	3.78%	ITA	5.03%
MEX	3.68%	ITA	3.33%	MEX	3.50%	FRA	3.85%
GBR	3.03%	GBR	3.24%	KOR	3.46%	GBR	3.34%
SGP	2.79%	FRA	3.07%	GBR	3.34%	MEX	3.01%
CAN	2.76%	CHE	2.40%	JPN	3.22%	KOR	2.76%
ITA	2.69%	MYS	2.02%	RUS	3.10%	NLD	2.08%
ROW	39.51%	ROW	23.97%	ROW	43.58%	ROW	30.81%

USA: United States of America; DEU: Germany; CHN: China; FRA: France; JPN: Japan; CAN: Canada; GBR: Great Britain; KOR: South Korea; MEX: Mexico; ITA: Italy; NLD: Netherlands; IND: India; SGP: Singapore; CHE: Switzerland; BEL: Belgium; MYS: Malaysia; ROW: Rest of the world.

**Table 3.** Summary statistics on variables.

<b>Variables</b>	<b>Mean</b>	<b>Standard deviation</b>	<b>Minimum</b>	<b>Maximum</b>
<b>1995</b>				
Imports of APEC List of EGs	36,929	204,243	0	3,978,146
Imports of OECD List of EGs	51,343	275,895	0	5,690,128
Imports of merged Lists of EGs	27,985	228,749	0	7,090,927
Importer GDP	9.72e+11	1.80e+12	7.02e+09	7.66e+12
Exporter GDP	1.80e+11	7.62e+11	9.52e+07	7.66e+12
Contiguity (=1)	0.017	0.130	0	1
Common official language (=1)	0.108	0.310	0	1
Common legal system (=1)	0.260	0.438	0	1
RTA (=1)	0.042	0.201	0	1
<b>2003</b>				
Imports of APEC List of EGs	41,843	276,095	0	6,121,546
Imports of OECD List of EGs	51,858	324,173	0	8,191,218
Imports of merged Lists of EGs	38,591	329,164	0	1.01e+07
Importer GDP	9.34e+11	2.09e+12	7.92e+09	1.06e+13
Exporter GDP	1.94e+11	9.09e+11	7.66e+07	1.06e+13
Contiguity	0.019	0.138	0	1
Common official language (=1)	0.096	0.294	0	1
Common legal system (=1)	0.253	0.435	0	1
RTA (=1)	0.072	0.259	0	1
<b>2012</b>				
Imports of APEC List of EGs	75,673	428,815	0	7,715,767
Imports of OECD List of EGs	92,926	552,05	0	1.23e+07
Imports of merged Lists of EGs	89,186	629,072	0	1.74e+07
Importer GDP	1.44e+12	2.98e+12	1.36e+10	1.62e+13
Exporter GDP	4.39e+11	1.55e+12	2.32e+08	1.62e+13
Contiguity (=1)	0.019	0.136	0	1
Common official language (=1)	0.092	0.289	0	1
Common legal system (=1)	0.243	0.429	0	1
RTA (=1)	0.091	0.287	0	1



**Table 4.** Benchmark results from Translog and CES gravity models

Variables	Translog Gravity Estimates		CES Gravity Estimates	
	(1)OECD List	(2)APEC List	(3)OECD List	(4) APEC List
	$(x_{ij}/y_j)/n_j$	$(x_{ij}/y_j)/n_j$	$Ln(x_{ij}/y_j)$	$Ln(x_{ij}/y_j)$
Log(distance)	-0.00011*** (0.00002)	-0.00048*** (0.0001)	-1.9833*** (0.0928)	-1.6500*** (0.0928)
Common border	0.00096*** (0.00034)	0.00390*** (0.0014)	1.1304*** (0.3067)	0.9479*** (0.2651)
Common language	0.00001 (0.00019)	0.00033*** (0.0001)	0.6583*** (0.1347)	0.8977*** (0.1376)
Common legal	0.00004*** (0.00001)	0.00010 (0.0001)	0.4193*** (0.0847)	0.2510*** (0.0851)
RTA	0.00022*** (0.0001)	0.00098*** (0.0003)	0.1149 (0.1574)	-0.0172 (0.1492)
Inverse Mills Ratio	0.00009*** (0.00002)	0.00068*** (0.0002)	1.8689*** (0.1174)	1.6488*** (0.1141)
Fixed effects	Yes	Yes	Yes	Yes
Clusters	4419	4040	3696	3574
Observations	53'983	41'251	25'845	31'896

**Notes:** Cluster-robust standard errors in parentheses, pooled data by pair (importer-exporter) \*\*\*significance at the 1% level, \*\*significance at the 5% level, and \*significance at the 10% level. Estimates (not reported) also include Variables include importer and exporter time varying fixed effects..

**Table 5.** Robustness check from Translog gravity model  $\left(\frac{x_{ij}/y_j}{n_j}\right)$

Variables	(1)		(2)		(3)		(4)	
	OECD List	APEC List	OECD List	APEC List	OECD List	APEC List	OECD List	APEC List
Log(distance)	-0.00020*** (0.00003)	-0.00063*** (0.0002)	-0.00013*** (0.00001)	-0.00055*** (0.0001)	-0.00015*** (0.00002)	-0.00054*** (0.00002)	-0.00035*** (0.00005)	-0.00092*** (0.00015)
Common border	-	-	-	-	0.00081 (0.00430)	0.02599 (0.01768)	0.00204*** (0.00045)	0.00572*** (0.00185)
Log(dist.)*Common border	-	-	-0.00014*** (0.00005)	-0.00054*** (0.0002)	-0.00024 (0.00066)	-0.00338 (0.00254)		
Common language	-	-	-	-	0.00040 (0.00087)	0.00152 (0.00452)	0.00004 (0.00007)	0.00065*** (0.00026)
Log(dist.)*Common lang.	-	-	-3.63e-07 (1.80e-06)	-0.00004*** (0.00001)	-5.05e-06 (0.00098)	-0.00014 (0.00050)		
Common legal	-	-	-	-	0.00067** (0.00030)	0.00139 (0.00131)	0.00012*** (0.00004)	0.00025* (0.00014)
Log(dist.)*Common legal	-	-	-4.5e-06*** (1.31e-07)	8.57e-06 (6.78e-06)	-0.00007** (0.00003)	-0.00015 (0.00015)		
RTA	-	-	-	-	0.00313*** (0.00064)	0.01457*** (0.00372)	0.00043*** (0.00018)	0.001390** (0.00071)
Log(dist.)*RTA	-	-	-0.00002** (9.61e-06)	-0.00009** (0.00004)	-0.00038*** (0.00008)	-0.00175*** (0.00046)		
Inverse Mills Ratio	0.00009*** (0.00002)	0.00063*** (0.0002)	0.00010*** (0.00002)	0.00069*** (0.00019)	0.00007*** (0.00003)	0.00047** (0.00019)	0.00045*** (0.00009)	0.00170*** (0.00035)
Fixed effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Clusters	4419	4040	4419	4040	4419	4040	4419	4040
Observations	54'000	41'267	53'991	41'254	53'965	41'224	53'983	41'251

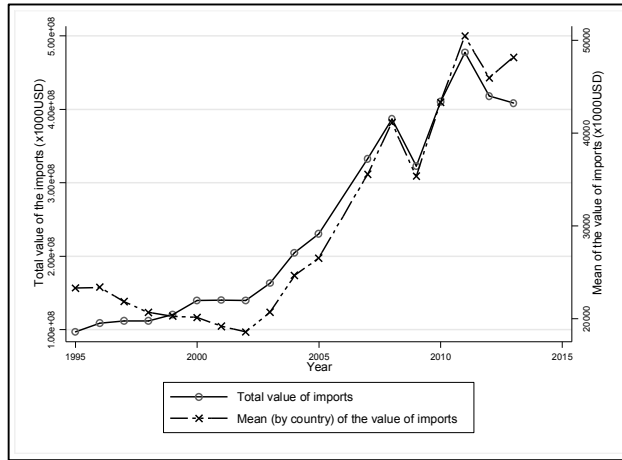
**Notes:** Cluster-robust standard errors in parentheses, pooled data by pair (importer-exporter); \*\*\*significance at the 1% level, \*\*significance at the 5% level, and \*significance at the 10% level. We included each estimations interact importer-year and exporter-year fixed effects. Estimates (not reported) also include Variables include importer and exporter time varying fixed effects.

**Table 6.** Elasticities of trade costs by quantiles based on import share

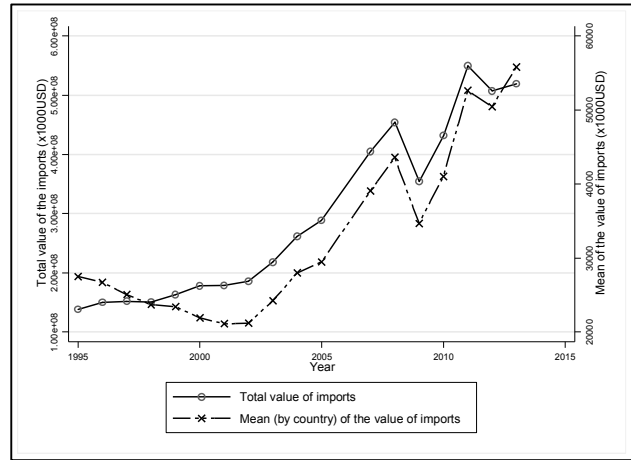
Quantiles	APEC List			OECD List		
	Mean of the import share	Mean of imports (x1000 USD)	Mean of Elasticity of trade costs	Mean of the import share	Mean of imports (x1000 USD)	Mean of Elasticity of trade costs
1	1.98e-07	1.742	102,015.900	1.60e-07	1.745	144,736.800
2	1.16e-06	8.827	6,853.277	1.06e-06	10.637	4,318.891
3	4.35e-06	32.106	1,890.553	4.54e-06	38.669	1,019.697
4	1.46 e-04	97.748	602.866	1.80e-05	144.621	307.791
5	5.15 e-05	317.067	197.458	7.07 e-05	552.050	89.236
6	1.97e-04	1,162.931	49.682	2.84 e-04	2,309.983	23.348
7	7.98e-04	4,148.865	14.476	0.001	7,538.247	6.316
8	0.003	17,712.790	3.946	0.003	28,301.600	2.339
9	0.011	69,599.000	1.228	0.011	87,313.670	0.782
10	0.094	477,153.000	0.209	0.087	578,356.000	0.154



## List of Figures



**Fig. 1a.** APEC List of EGs



**Fig. 1b.** OECD List of EGs

**Figure 1.** Total value of trade of EGs and average of imports from 1995-2012.

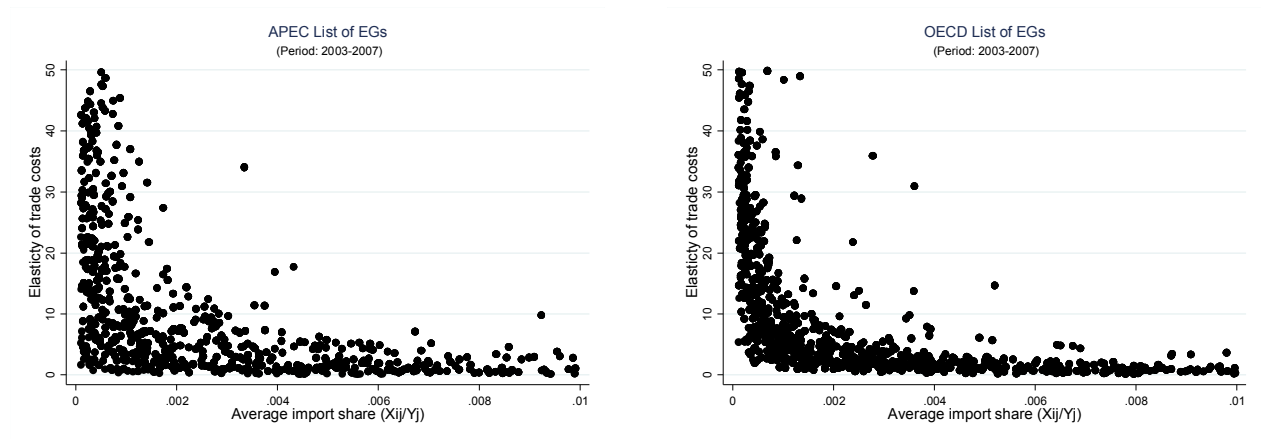


Fig. 2a. Period 2003-2007

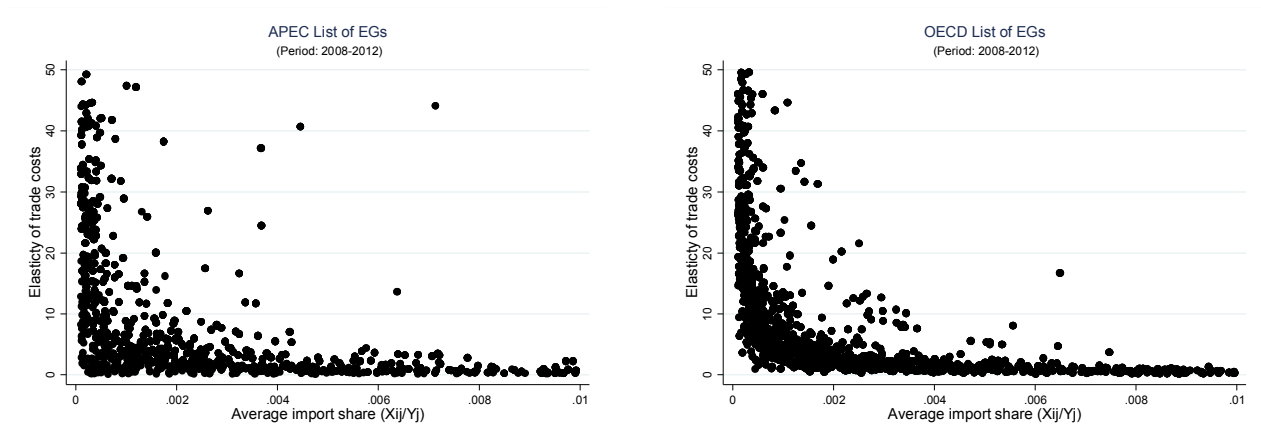
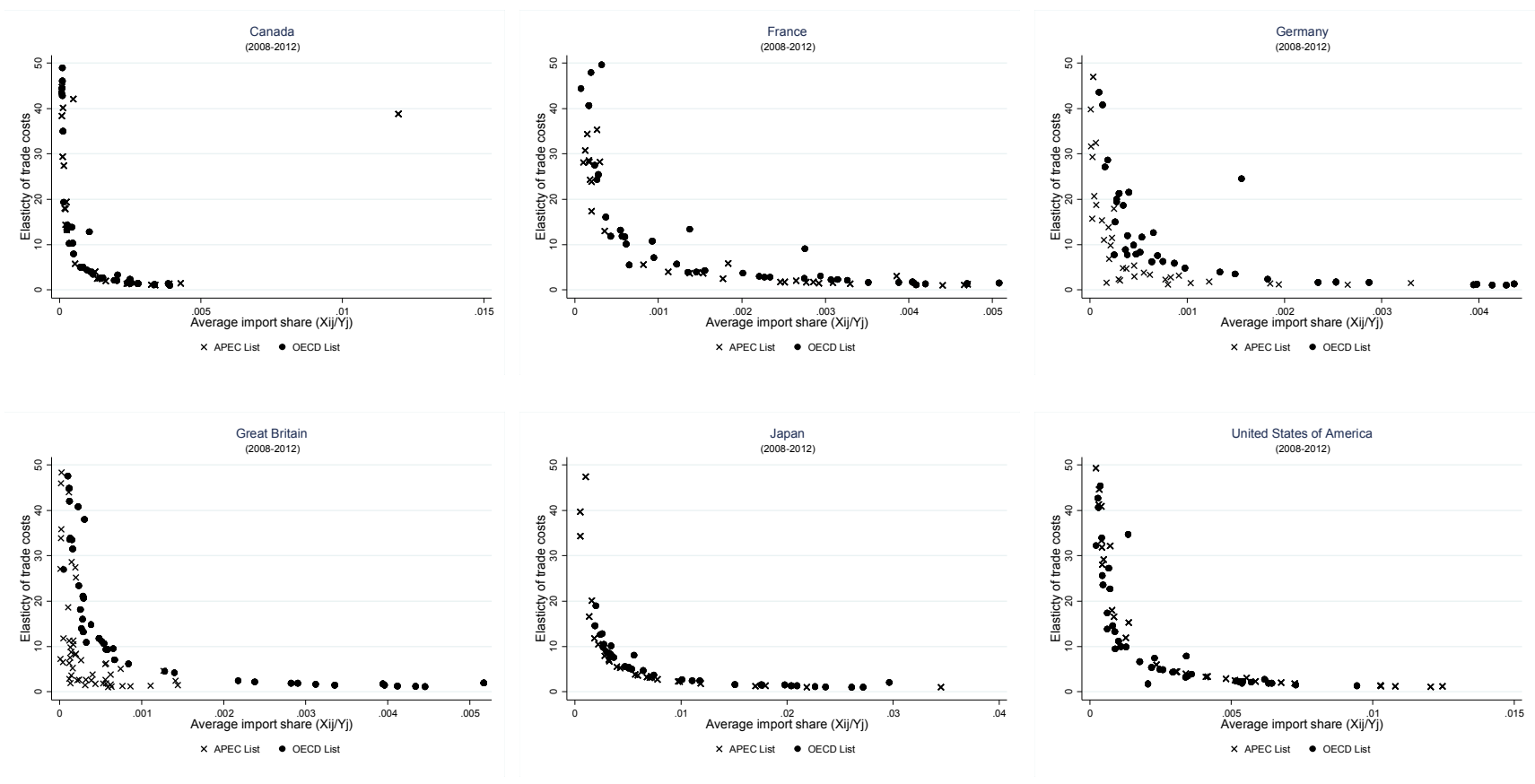


Fig. 2b. Period 2008-2012

Figure 2. Elasticities of trade costs of EGs of APEC and OECD Lists by different periods



**Figure 3.** Difference between elasticities of trade costs (APEC & OECD Lists) for some selected countries from 2008 to 2012.

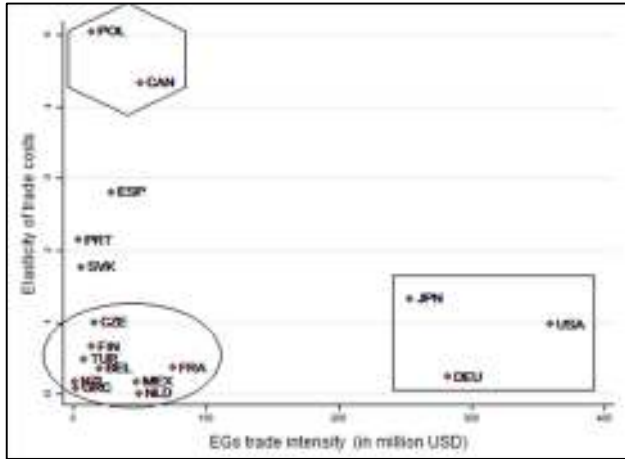


Fig. 4.1a. APEC List of EGs

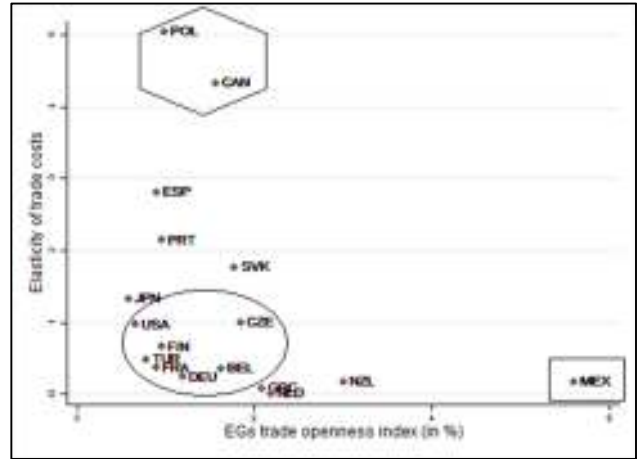


Fig. 4.1b. OECD List of EGs



Fig. 4.2a. APEC List of EGs

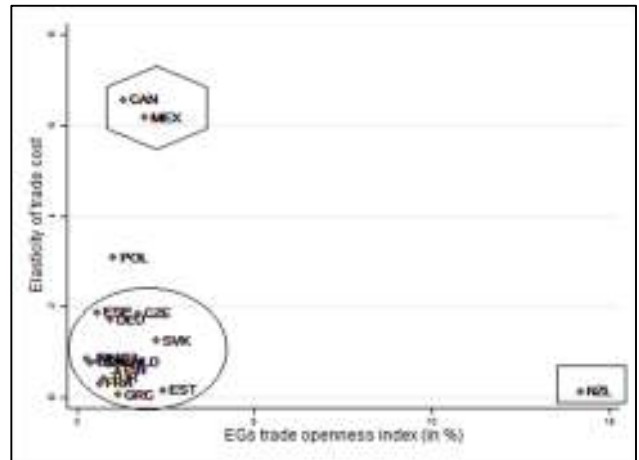


Fig. 4.2b. OECD List of EGs

AUS: Australia; AUT: Austria; BEL: Belgium; CAN: Canada; CHE: Switzerland; CHL: Chile; CZE: Czech Republic; DEU: Germany; DNK: Denmark; ESP: Spain; EST: Estonia; FIN: Finland; FRA: France; GBR: United Kingdom; GRC: Greece; HUN: Hungary; ISL: Iceland; NOR: Norway; NZL: New Zealand; POL: Poland; PRT: Portugal; SVK: Slovak Republic; SVN: Slovenia; SWE: Sweden; TUR: Turkey; USA: United States..

Figure 4. Relation between elasticity of trade costs and trade intensity for some selected countries

## Appendix

**Table A1.** List of countries

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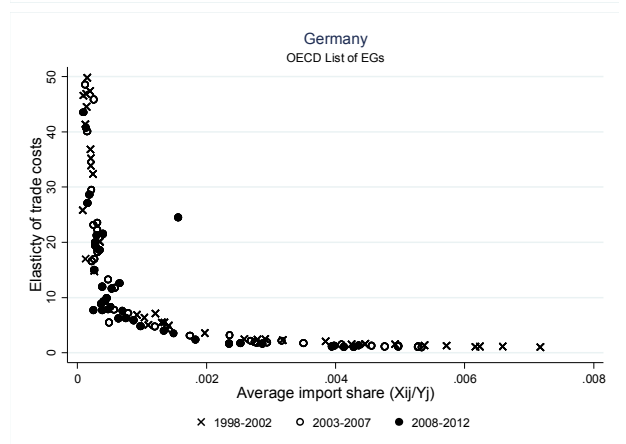
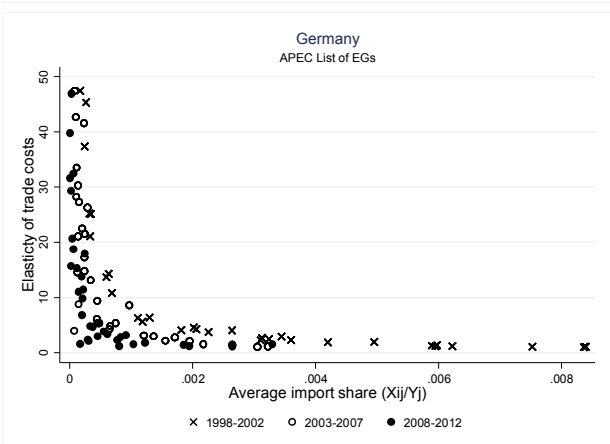
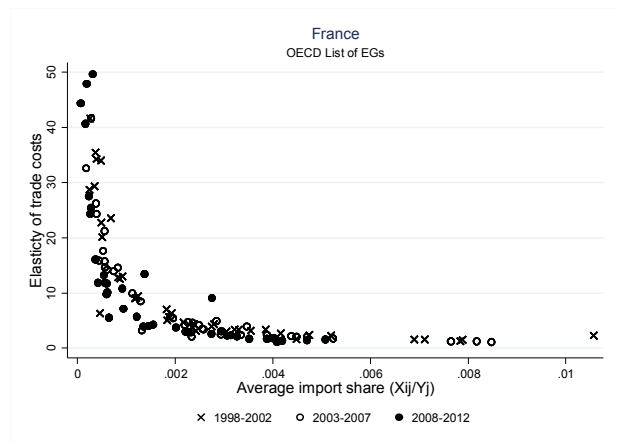
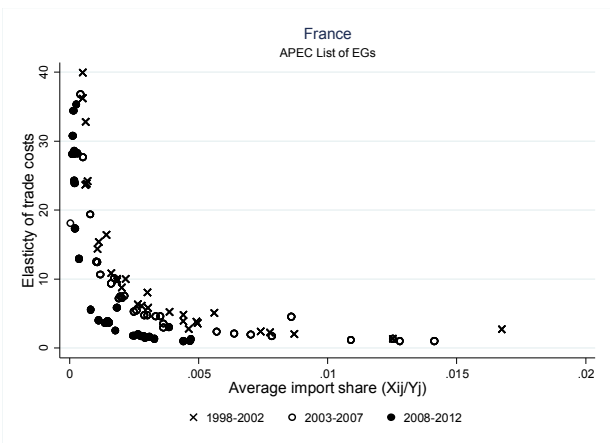
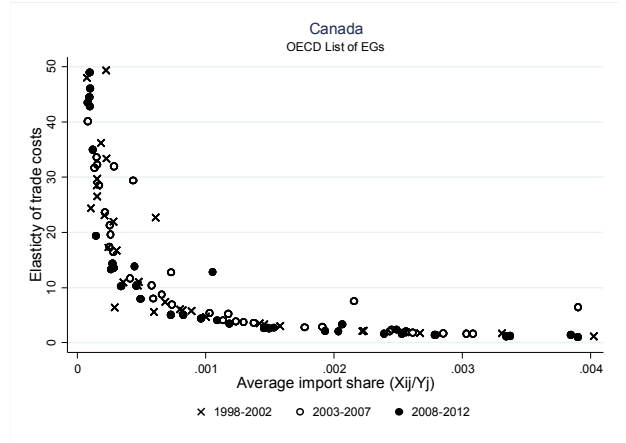
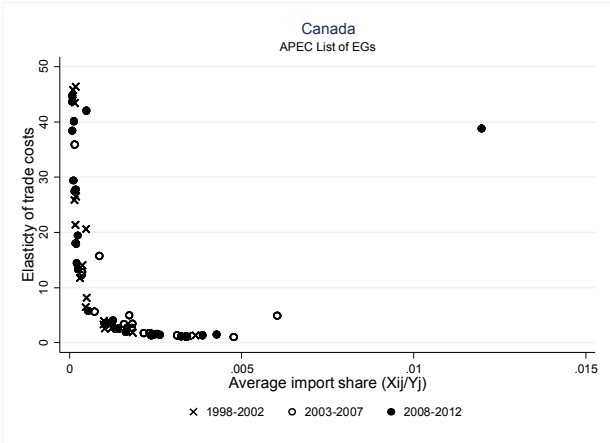
Albania	Congo	Iran	Myanmar	Suriname
Algeria	Costa Rica	Iraq	Namibia	Swaziland
Angola	Croatia	Ireland	Nepal	Sweden
Argentina	Cuba	Israel	Netherlands	Switzerland
Armenia	Cyprus	Italy	New Zealand	Syria
Australia	Czech	Ivory Coast	Nicaragua	Taiwan
Austria	Denmark	Jamaica	Niger	Tajikistan
Azerbaijan	Djibouti	Japan	Nigeria	Tanzania
Bahamas	Dominica	Jordan	Norway	Thailand
Bahrain	Dominican Rep.	Kazakhstan	Oman	Togo
Bangladesh	Egypt	Kenya	Pakistan	Trinidad and Tobago
Barbados	El Salvador	Korea	Palau	Tunisia
Belarus	Equatorial Guinea	Kuwait State	Panama	Turkey
Belgium	Eritrea	Kyrgyzstan	Paraguay	Turkmenistan
Belize	Estonia	Lao	Peru	Uganda
Benin	Ethiopia	Latvia	Philippines	Ukraine
Bhutan	Finland	Lebanon	Poland	United Arab Emirates
Bolivia	France	Lesotho	Portugal	United States of America
Bosnia and Herzegovina	Gabon	Liberia	Puerto Rico	Uruguay
Botswana	Gambia	Libya	Qatar	Uzbekistan
Brazil	Georgia	Lithuania	Romania	Venezuela
Brunei	Germany	Luxembourg	Russia	Vietnam
Bulgaria	Ghana	Macedonia	Rwanda	Yemen
Burkina Faso	Great Britain	Madagascar	Sao Tome and Principe	Zambia
Burundi	Greece	Malawi	Saudi Arabia	Zimbabwe
Cambodia	Grenada	Malaysia	Senegal	
Cameroon	Guatemala	Mali	Seychelles	
Canada	Guinea	Malta	Sierra Leone	
Cape Verde	Guinea-Bissau	Mauritania	Singapore	
Central African	Haiti	Mauritius	Slovakia	
Chad	Honduras	Mexico	Slovenia	
Chile	Hungary	Moldova	South Africa	
China	Iceland	Mongolia	Spain	
Colombia	India	Morocco	Sri Lanka	
Comoros	Indonesia	Mozambique	Sudan	

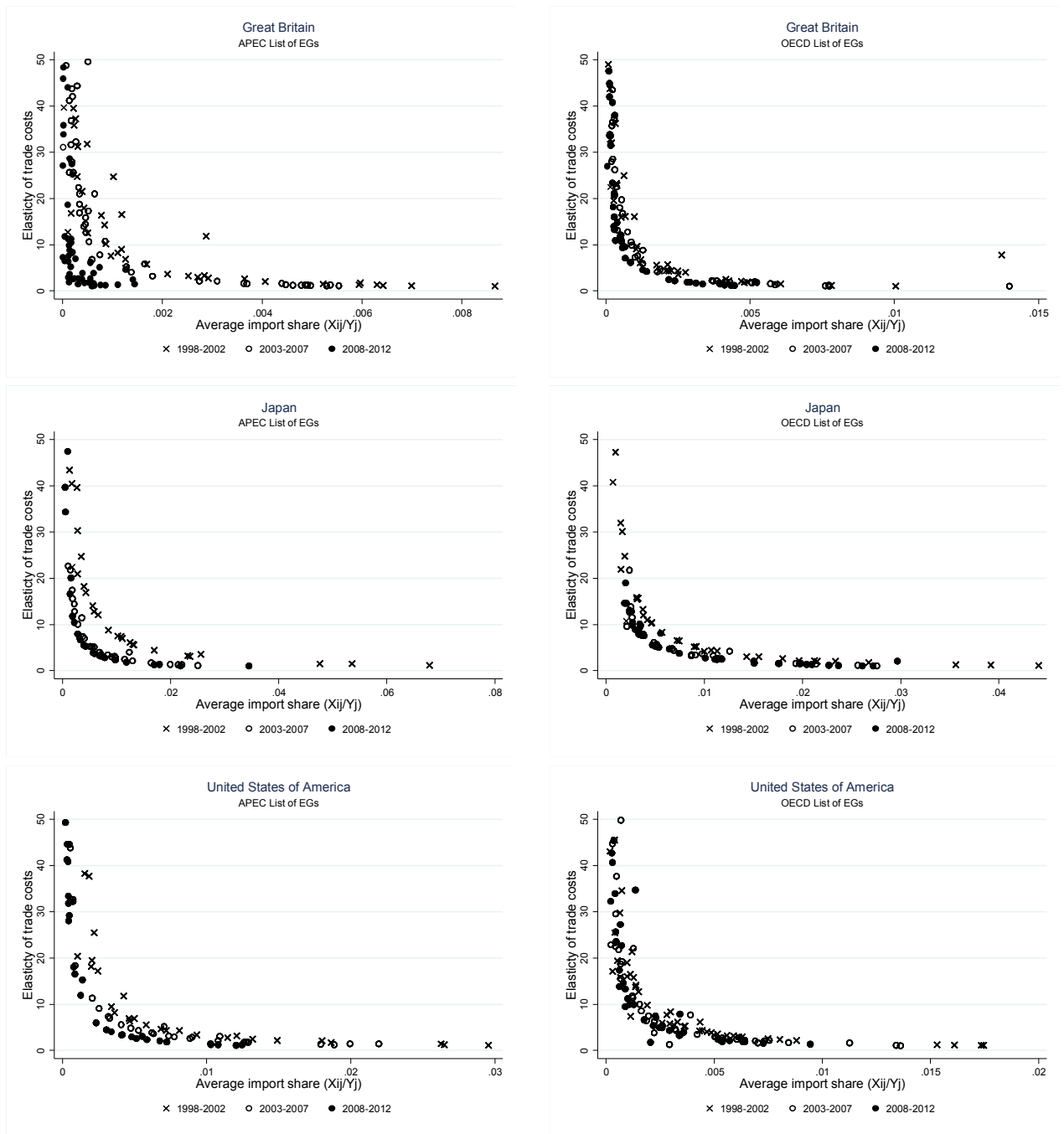
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**Table A2.** First stage Probit model estimations results

<b>Variables</b>	<b>OECD List</b>	<b>APEC List</b>
Log(distance)	-0.657*** (0.053)	-0.650*** (0.054)
Common border (=1)	0.495 (0.352)	0.948*** (0.316)
Common language (=1)	0.502*** (0.073)	0.665*** (0.075)
Common currency (=1)	-0.367 (0.296)	-0.610 (0.371)
Trading partners have signed the GATT (=1)	0.236 (0.402)	-0.552 (0.701)
Common legal system (=1)	0.100*** (0.039)	0.236 ( 0.042)
RTA (=1)	0.037 (0.107)	0.146 (0.096)

**Notes:** Cluster-robust standard errors in parentheses, pooled data by pair (importer-exporter); \*\*\*significance at the 1% level, \*\*significance at the 5% level, and \*significance at the 10% level. We included each estimations interact importer-year and exporter-year fixed effects. Estimates (not reported) also include Variables include importer and exporter time varying fixed effects.





**Figure A1.** Evolution of elasticities of trade costs for some selected countries